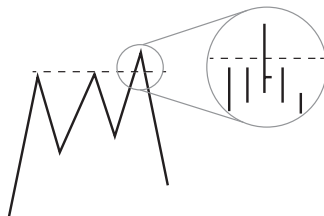


FAILURE TEST



Trade Type

Support/resistance holding or trend termination.

Concept Markets probe for stop orders and activity beyond significant price levels. Many times, there is no real conviction behind these moves, and the moves fail and reverse quickly once the stop orders are triggered. Entering after such a move allows for excellent reward/risk potential with a clearly defined risk point.

Setup The market must be overextended or in some way primed for reversal. The best examples of this trade occur in mature, extended trends, and will usually be accompanied by momentum divergence on the trading time frame. Another common variation occurs in an extended consolidation just under resistance. This type of consolidation would normally have a high expectation of producing another trend leg above that resistance, so many traders are monitoring the area and will enter on a potential breakout. If this breakout occurs and fails, there will be many trapped traders, which can add momentum to a downside trade off that level.

Trigger For a short entry, the market trades above a clearly defined resistance area, but immediately reverses on the same or the following bar and closes back under the resistance. There can be significant volatility, volume, and activity on the breakout, but there should be no real conviction beyond the level. Enter short on the close of the bar that closes back below resistance. The buy setup is exactly symmetrical. Figure 6.1 shows examples of long and short failure test entries in Fossil, Inc. (Nasdaq: FOSL). Point A marks a brief probe below support, but the same day immediately closed back above the support level. At B, the stock attempted to break to new highs, but there was not enough buying pressure to hold it above the resistance level and it failed on the same day. A long entry would have been justified on the close of A, and a short on the close of B.

Figure 6.2 shows another classic example of this trade, in the EURUSD. In the bar preceding A, all systems seemed to be “go” for a continued trend run above the previous highs, and the market actually closed solidly above the resistance level. However, at A

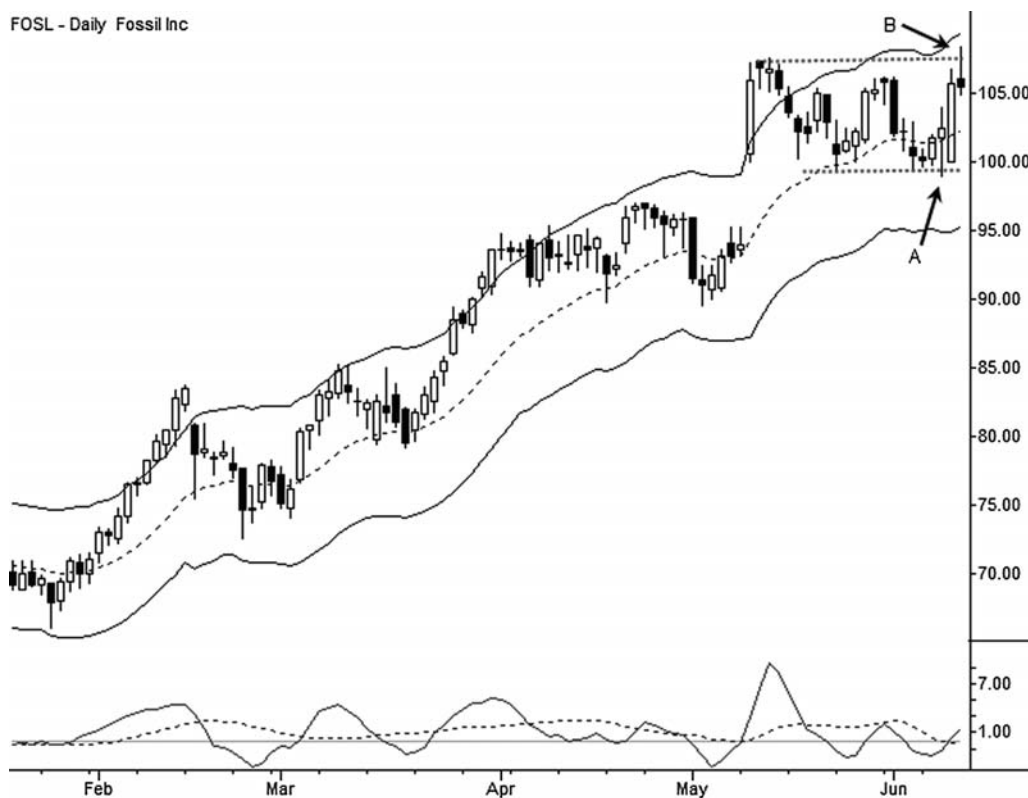


FIGURE 6.1 Two Failure Test Entries in FOSL

the market failed dramatically, and the subsequent sharp selling shows that this point did in fact mark a major structural inflection in this currency.

Stop The stop for this trade is clearly defined: a hard stop must be entered just beyond the extreme of the test beyond the level. For instance, the stops on the two trades in Figure 6.1 would have been placed below the low of the bar marked A and above the high of B. The EURUSD trade in Figure 6.2 is only slightly more complicated; the failure occurred on the close of the day marked A, but the previous day set the high-water mark for the excursion above resistance. Therefore, you would have had to place the stop above the high of the bar *preceding* the entry bar. In all cases, the stop goes just outside the most extreme test beyond the triggering support or resistance level.

Because this is an aggressive countertrend trade, it is important to not add to losing trades. Respect the stop level without question. In addition, there is significant gap risk with trades held overnight. On losing trades, there is sometimes enough pent-up pressure to cause gap opens beyond the stop, so it may make sense to trade these on smaller size and risk compared to other setups.



FIGURE 6.2 A Failure Test Short in the EURUSD

Profit Target Most traders find best success with a plan that allows for taking partial profits as the market makes them available. For instance, one plan would be to take profit on the first part when the profit equals the initial risk on the trade. The profit target on the second portion is discretionary, but consider the possibility of a longer, complex correction that leads to continuation of the original trend. Some of these trades will turn into dramatic trend reversals, but this should not be your baseline expectation. In general, consolidation near the level, particularly if the first profit target is not reached, is a bad sign. For instance, if you enter short on B in Figure 6.1 and the market spends two to three days trading above 105, this is most likely a precursor of a losing trade. Reduce exposure or close out these trades if they do not work quickly in your favor.

Failure Patterns While it is certainly important to know what the pattern should look like if it's working, from a pedagogical standpoint it probably makes more sense to focus energy and attention on what should *not* happen. If these early signs of failure can be recognized, it is often possible to reduce position sizes and to reduce the size of the ultimate loss. In addition, careful study of the typical patterns associated with failure can lead to a deeper understanding of the dynamics behind the trade. The key to most failure

patterns is to understand what should *not* happen if the trade is good—to look for price action and emerging market structure that contradict the reasons for being in the trade.

In this case, what we do not want to see after trade entry is simple: the market should not be able to consolidate near the level, nor should it exceed the stop-loss point. Consolidation near the level is more consistent with an impending breakout and continuation of the existing trend. If the failure test trade is successful, price should move sharply away from the level, and the trade should be immediately profitable (within one to three bars on the trading time frame). This is another expression of the classic price rejection, a further confirmation of the validity of the failure beyond the level.

One last point to consider is that some of these trades will hit the stop point and, on the same or the next bar following the stop-out bar, will once again fall back inside the level. Though it can be psychologically challenging to reenter immediately after a loss, this second trade, taken on the second failure, is also an excellent entry. This is another reason for trading both entries on smaller risk—this second entry sets up often enough (and is virtually obligatory) that the sum of the risk on both trades should not be significantly larger than the maximum risk taken on other types of trades.

Comments This is the simplest and most clearly defined of all the patterns in this chapter. There is no subjectivity in stop location and little subjectivity in managing losing trades—if the market makes a new extreme, then you are wrong and must exit the trade. There are only two potential complications with this trade. The first is the reentry following a stop-out, which is usually a simple failure on the higher time frame. Traders must be aware of this possibility and must plan for this in their risk management and position sizing.

The second potential issue deals with managing winning trades; it is important to consider the trade-off between high probability of a smaller profit and the lesser probability of a large payout. Some percentage of these trades will evolve into major trend reversals; however gratifying that is, it is not the most common outcome and should not be your expectation when trading this pattern. Many winning trades will give the trader the opportunity to take some profits around the first profit target, at which point the market begins consolidating or turns around and hits the stop. It is important to strike a balance between taking sufficient early profits that the entire set of trades will be profitable, while maintaining enough exposure that the much less common home runs make a significant contribution to the bottom line. There is no easy answer to this, and the choice will depend on a large degree on the personality and inclination of the individual trader.

The failure test pattern is the classic Wyckoff spring and upthrust; the only adaptation is the addition of a firm stop level and a concrete trading plan. The basis of this pattern was first written about nearly 100 years ago, and it works just as well today. More recently, Victor Sperandeo (1993) has written about this pattern, which he calls the “2B” trade. His books include many valuable ideas and perspectives on this pattern and other trading-related issues.